on foreign official holdings of Deutschemark, yen, Swiss franc and Dutch guilder resulting, in part, from the current payments deficits of those countries at various times since 1979. However, the Euromarkets continue to attract central bank placements because of the higher yields available, as well as the flexibility and anonymity of these markets.

Diversification will continue, in the view of most respondents, although they see limitations to that process, partly because very few countries have markets of a breadth and depth which would make their currencies suitable as foreign official assets on any significant (or significantly larger) scale: one referred specifically to the shortage of liquid money market instruments in the 'new' reserve currencies — others to the 'narrowness' of non-dollar markets generally.

Countries that are large borrowers can achieve most of their diversification goals by a more active management of their debt structure; the replies yielded some evidence to substantiate this point, which was made by a G-10 central bank.

The maintenance of a currency mix appropriate to the pattern of foreign trade and of external indebtedness was seen as the most important influence on the management of reserves at present.

MCRS in practice

Destabilizing . . . In the view of most central banks who cooperated in this study, the trend towards the MCRS may have a marginally destablizing influence, but they attribute the main causes of instability in exchange and interest rates to unstable economic conditions and monetary policies; moreover, the impact of switching by official holders is thought to be much less than that of private investors.

. . . or, stabilizing? However, several other respondents believe that the MCRS may actually contribute towards stability at the margin, by spreading responsibility for adjustment among more centers. In particular, in such a system the dollar faces competition from other currencies and this "may tend to constrain dollar creation." Official currency switching can reinforce the signals for economic adjustment to the older and newer reserve centers and thus contribute to prompter adjustment by those centers when necessary.

Active portfolio management of part of their reserves by a growing number of central banks is tending to blur the distinction between their behavior and that of other participants in world financial markets. The impact on the financial system may vary greatly according to whether official "diversified portfolios" are managed aggressively (like "performance funds") or cau-

tiously. The evidence suggests that some central banks tend towards the first course and others towards the latter.

"Rational" behavior by "large new holders of reserves, primarily OPEC countries" was favorably commented on by a G-10 central bank. Similar observations were made by a few other central banks, acknowledging the profit-oriented yet prudent portfolio management policies of some of these large new reserve holders. Such policies will tend to have a stabilizing influence on the exchanges.*

"Irrational" behavior, on the other hand, was reported by several commercial bankers. They said that diversified reserve holders often act "perversely" by selling out of falling markets and buying into rising markets, thus contributing to exchange rate instability. One investment banker spoke of "wild and ill-informed trading" in currencies and commodities by some of his official clients, adding that they frequently lose money.**

Policy issues

The de facto MCRS is here to stay, according to most respondents. "We cannot go back to the dollar alone or forward to the SDR" said one G-10 central banker. Most central banks surveyed expect the SDR's role to remain modest, and there was surprisingly little difference of view between industrial and developing countries. Nor did most respondents see an alternative to the MCRS in a substitution account of the type proposed in 1979/80, which would have substituted SDR claims on the IMF for some of the official dollar claims on the US. At the same time, most respondents doubt whether any general understanding could be reached between reserve centers and holders on rules or guidelines for diversification, although several thought the idea worth exploring.

Other policy issues arising from the replies were the following:

1. In the view of several central banks, the extent of further reserve diversification will be strongly influenced by US monetary policy and the American authorities' attitude to the dollar's exchange rate including, but not limited to, intervention policy;
2. Replies suggest that insofar as measures to reduce exchange rate instability associated with an MCRS might be desirable, central banks look in the first instance to the central banks of reserve centers to make the necessary arrangements with each other;

* An example of this has been publicly provided by Mr. AlQuraishi, the Governor of the Saudi Arabian Monetary Authority. He has said that SAMA's policy is to buy into falling markets and to stay in or sell out of rising markets. *The Banker*, London, July 1981, page 77.

** One example, recently reported, referred to estimated losses of "well over $25 million, or as much as the paid-up capital" of the Abu Dhabi Investment Company, created in 1977 as a merchant bank and investment vehicle for that state's official funds. *The Economist Financial Report*, December 10, 1981.

3. Further, the replies taken together suggest that if the financial community should at some point in the future wish to move decisively away from the dollar, a successor to the dollar would have to fulfill all the functions of a reserve currency, including particularly its ability to serve as a means of direct intervention in the foreign exchange markets.

Conclusions

Most of the respondents to this survey believe that there is no practical alternative to the *de facto* MCRS that has come into being. They foresee a further if limited tendency towards reserve currency diversification and more active asset management through a wider range of market instruments by reserve holders. Most of them see little prospect of official management of the phenomenon; but they do not seem to be strongly concerned about this.

Some central banks believe reserve diversification adds marginally to international financial instability. Others believe that it does or could make a marginal contribution towards the stabilizing of exchange relationships. The outcome would seem to depend partly on the extent to which official asset holders perceive an identity between their own longer-term investment interests, and the contribution which that perception could make towards stabilization.

The Development of a Multi-Currency Reserve System

Report on Central Banks' Replies
to Questionnaire

PART 1: THE MANAGEMENT OF RESERVE ASSETS

1. Please list in order of importance, in your personal opinion, the factors that have contributed to the process of reserve currency diversification by many central banks in recent years (comments on those factors would be helpful):
   - i) the expectation of long-lasting trends in exchange rates, such as a depreciation of the US dollar
   - ii) short-term fluctuations in exchange rates without regard to trend
   - iii) interest rate instability
   - iv) changing trade patterns
   - v) a new desire for capital inflows on the part of some industrial countries
   - vi) a new desire to increase the overall return on reserve assets on the part of central banks
   - vii) a desire to match the currency composition of reserve assets with that of external liabilities
   - viii) the ready availability of diversification opportunities through the Euro-currency (or comparable) markets

Respondents' answers

Nearly all agree that the dollar's almost continuous decline and large exchange rate fluctuations from 1971 onward gave the original impetus to reserve diversification and more active reserve asset management.

The replies suggest that, once started, the main factor contributing to diversification and more active reserve asset management was the desire of many countries to maintain the real value of their resources at a time of steeply rising liquidity or at least to increase the return on their assets. That became additionally important for commodity producers whose reserves increased substantially after the 1972/73 raw materials' boom and for oil exporters whose reserves rose sharply after the large increases in world oil prices in 1973 and 1979. Reaction to wide interest rate fluctuations coming on top of large exchange rate fluctuations from 1979 then became an important further influence motivating central banks to increase the return on reserve assets or maintain their value through currency diversification and active portfolio management. In other words, respondents tended to list the "factors" in the sequence of their influence over time, rather than in their relative importance at any given moment.

The desire to match foreign exchange liabilities and assets acquired growing importance on changing patterns of trade and even more so because of heavy balance of payments borrowing by many countries after 1973. Several banks also stated that foreign currency matching became important in guiding the direction and extent of diversification rather than originally motivating diversification.

Finally, there are the markets that have contributed to diversification and more active asset management, as distinct from motivating those trends. The Euromarkets make possible diversification both by currencies and the location of where assets are held. They were well established even before reserve diversification began, but have grown significantly during the past decade both in size and in the variety of investment instruments available. More recently, some countries have partly eased the restrictions they formerly imposed on the use of their currencies as reserve assets in response to deteriorations in their balances of payments, notably Germany, Japan, Switzerland and the Netherlands.

2. Do you expect that a general process of reserve currency diversification will persist?

Respondents' answers

The reply was an almost unanimous "yes" excepting from one central bank which said it was unsure and another which declined to answer this

question. The reason most commonly given was summed up by a Group of Ten central bank which said: "Diversification is likely to persist under conditions of strongly growing liquidity and indebtedness combined with instability of interest and exchange rates." "There is no alternative," said another G-10 central bank which added, as most respondents did explicitly or implicitly, that it foresees no early return to enduring international financial stability. The matter was put somewhat differently by a third G-10 central bank which said, "Even periods of dollar strength may also serve to permit diversification with more ease and less embarassment to the United States". At another level, the central bank of one of the smaller Latin American countries said that its reserve diversification would be "strictly tied to the development of our foreign trade and foreign capital inflows".

3. Have the objectives, or priorities among the objectives, of your reserve policy changed significantly over the past five to ten years? If there have been significant changes, could you indicate what they have been and the principal reasons for them?

Respondents' answers

More than half the respondents reported no fundamental change in objectives or priorities in the past five or even ten years, although several said that they had improved their techniques of diversification and asset management over time. However, a minority did report changes of objectives. They include:

- A G-10 central bank which said that its initial objective had been to maintain cover for its non-dollar liabilities. More recently, its diversification had "moved towards a more positive approach to a more balanced portfolio";
- Another G-10 central bank similarly reported that large exchange rate movements had recently made it more "sensitive" to the need for stabilizing the value of its reserves by holding a more balanced portfolio of currencies other than the dollar;
- A third G-10 central bank said: "One new objective for our reserve policy has been established over the last five years: to achieve a currency mix in reserves which at least to some extent reflects official indebtedness. Furthermore, the yield aspects of reserve management have become more important over the past five years";
- A fourth G-10 central bank reported that it had made modest gold

sales in recent years so that more of its reserves might be invested in interest-bearing securities;

- The central bank of a smaller, European industrial country said that it had taken advantage of the recent relaxation of restrictions in secondary reserve centers to acquire a portfolio of assets which "is now well spread over a range of currencies";
- The central bank of an industrial country outside the G-10 said it had shifted to a new emphasis on liability management in recent years by arranging short-term credit lines to be drawn down in times of external deficit and repaid in times of external surplus;
- An oil producing country said it had progressively adapted its reserve management policy to reflect higher oil earnings and the diversification of its imports during the 1970s.

4. Recognizing that there are wide differences between the policies of different central banks, particularly with regard to reserve diversification, if you now hold a number of currencies in your reserves, could you please indicate which of the following considerations are important influences on your present management of those reserves (comments would be appreciated):
   i) asset preservation over the longer term
   ii) maximization of total yields over the longer term (i.e. yields after allowing for appreciation or depreciation of currencies held)
   iii) opportunities for more active portfolio management
   iv) maintenance of a currency composition appropriate to patterns of international trade in goods and services
   v) maintenance of a currency mix appropriate to the currency structure of overseas indebtedness
   vi) protection against the possibilities of an asset freeze in one center
   vii) continuity of relationships with international commercial banks on the part of monetary authorities that place some of their reserves with commercial banks

Respondents' answers

The maintenance of a currency mix appropriate to the pattern of foreign trade and external indebtedness was cited as the most important influence by a majority of respondents, closely followed by the desire for asset preservation over the longer term and maximization of yields, which were given equal importance. Very little importance was attached to the

other influences cited. One European central bank summarized this by saying: "The matching of external assets and liabilities is the most important factor for us. Asset preservation and yield maximization come next. The other factors are insignificant or have no importance at all".

There was no discernible difference of emphasis in the answers received from central banks in the G-10, other industrial, oil-exporting and developing countries, excepting that the five central banks which declined to answer this question included three from the Group of Ten which said that the question did not apply to them because they continue to hold nearly all of their foreign exchange reserves in dollars excepting for minimal working balances in some other currencies.

The central bank of a small industrial country said that the first stage of its reserve management was the selection of a desired currency mix with the object of preserving so far as possible the real value of its reserves at minimum risk. Having taken that long-term view, the bank added that it does not switch frequently between currencies. The second stage of its reserve management consists of selecting investment instruments in each of the currency markets chosen, but with prudential limits for various portfolio variables; "for example the time weighted average life of investments, the maximum maturity for bonds, the maximum proportion that may be invested in bonds, the maximum that may be placed with commercial banks, and so on".

Although the monetary authorities of oil exporting countries were among the minority which referred to the risk of an asset freeze as one influence on their reserve management, they rated it low down among their considerations.

5. If you presently aim for some further currency diversification, what factors limit or might limit the process in your case? The following lists a number of possible constraints (again comments would be appreciated):
    i) reimposition (or increasing likelihood) of restrictions on non-residents in-flows by some reserve currency countries
    ii) limit in the number of domestic financial markets of sufficient size to offer scope for large-scale diversification
    iii) political pressure by some recipient countries to limit official capital inflows from abroad
    iv) slower growth in the breadth and depth of some of the biggest existing financial markets
    v) concern over the reliability of "extra-territorial" markets for providing the liquidity appropriate for reserve assets

Respondents' answers

Nearly half the respondents to this questionnaire did not answer this particular question on one of two grounds: that they had not diversified their foreign exchange reserves, or that they do not at present intend any further diversification.

Those that answered cited as the two most limiting factors the possible reimposition of restrictions on official non-resident holdings in some of the newer, secondary reserve centers and the limited number of domestic financial markets of a sufficient size to offer scope for large-scale diversification. Far less importance was attached to the other possible limitations cited, like the possibly slower growth of the bigger existing financial markets and the liquidity of extraterritorial markets.

Among the comments made was this, by a central bank in the Group of Ten: "Restrictions on non-resident capital inflows might become a constraint again, not so much because ways will not exist of getting around such constraints but because the spirit of central bank cooperation, at least among G-10 and certain other countries, would inhibit their use."

6. Moving from the objectives to the instruments of policy, do you think that central banks in general manage their reserves more actively than formerly (say, five to ten years ago), in the sense of changing maturity structure and asset composition? Would you judge that your own management has become more active?

Respondents' answers

With the exception of two respondents which did not answer this question, all said that they believe central banks generally manage their reserves more actively than in the past and that they themselves did so. The respondents who gave this reply include several banks of the G-10 countries, some of which say they have been doing so partly by currency diversification. Others, which still hold their foreign exchange reserves almost exclusively in dollars excepting for minimal working balances elsewhere, nevertheless said that they now manage the maturity structure of their dollar assets more actively than before. "We have widened the number of our investment instruments in the United States", said one.

One major G-10 central bank, which said it had begun currency diversification of its own reserves in the latter 1970s, added: "Certainly our own management has become more active, but regular contacts with other G-10 countries suggest growing activity among some of their number".

The monetary authority of an important oil-exporting country referred to the "advantages of applying the principle of portfolio management to foreign exchange reserves in a world of floating currencies". However, it added a cautious note, "As a risk-averse institution, a central bank has to think of ways of reducing the political and economic risks of reserve holdings placed abroad. This implies a mix in its reserve holdings in terms of currencies and location".

7. A significant proportion of reserve currency diversification, especially on the part of oil exporters, developing countries and some smaller industralized countries has been through the Euromarkets. What, in your opinion, are the main reasons?
   i) greater confidentiality
   ii) absence of controls
   iii) higher yields
   iv) greater flexibility in amounts, timing, and choices of liquid assets

Respondents' answers

Higher yields followed by greater flexibility were cited as the main attractions of the Euromarkets as a channel for reserve diversification. Confidentiality and the absence of controls were ranked about equally in third place.

One bank pointed out that in the early days of reserve currency diversification the Euromarkets were often the only channel available. But, it added, even before diversification many central banks had become accustomed to the higher returns obtainable from commercial banks in the reserve centers compared with the returns on the government obligations of reserve currency countries held at the central bank of those countries.

Another central bank pointed out that in the case of the Deutschemark, the absence of controls in the Euromarket was especially important by contrast with restrictions on non-resident investment in the German domestic market (with similar restrictions applying in several other centers).

The central bank of an industrial country remarked that its credit facilities at international commercial banks influenced the deployment of its currency reserves through those same banks, often in the form of Eurocurrency deposits.

A point made by the central bank of a smaller European country was

that although it was attracted by the higher yields obtainable in the Eurocurrencies interbank markets, in the case of bonds it preferred to invest in foreign domestic bond markets rather than the Eurobond market, because of the greater liquidity of the former.

Two LDC central banks were among the minority of respondents which cited the greater confidentiality of the Euromarkets as their greatest attraction.

Several respondents recalled that the placement of funds in the Euromarkets by the central banks of the Group of Ten and Switzerland remains limited under an understanding reached between them in 1971 and renewed in 1979.

8. Is the average maturity of your holdings of claims denominated in the "new" reserve currencies markedly different from that of your dollar holdings?

Respondents' answers

A majority of respondents holding "new" reserve currencies said that the average maturities of such holdings were no different from those of their dollar assets.

A minority, however, said that the maturities of their dollar holdings were, on average, shorter. The reason was given by one of these central banks which said, "The dollar continues to be our main intervention currency and therefore requires a higher degree of liquidity than others".

By contrast, two central banks of smaller industralized countries said their "new" reserves were held at shorter average maturities than their dollar assets because of the lesser degree of liquidity in the "new" reserve centers.

Those central banks which reported no marked difference between the average maturities of their dollar and other currency assets explained that their overriding concern was high liquidity in whatever currencies they invested. Indeed, this strong liquidity preference seems to be common to many respondents, their differing answers suggesting merely differences in tactics for achieving a common objective.

Making a slightly different point, a European central banker said that the maturity of his bank's reserves is influenced by their level rather than their currency composition; the higher the reserves in relation to the outlook for the balance of payments, the longer the maturities of assets the central bank could afford to hold in whatever currency.

9. How frequently do you review your policy guidelines with regard to reserve composition and take decisions as to appropriate changes?

Respondents' answers

The difference in the degree of actual surveillance may be less than suggested by the variety of answer to this question. Some banks said they reviewed policy annually, others at intervals of six months, monthly, weekly or "continously". In reality, most respondents said that changes were made whenever developments seemed to make them appropriate.

"Investment policy is examined as often as necessary depending on developments in the markets" said an LDC central bank. "Decisions are taken in response to exchange rate developments and market intervention needs" said a G-10 central bank.

A different point was made by a European industrial country's central bank, which said that although it kept its reserve composition under regular review, it changed the composition of its reserves only infrequently on the basis of a medium to long-term view.

The monetary authority of an oil exporting country said it likewise did not change the composition of its foreign exchange reserves frequently. "Furthermore, operations have to be conducted in such a way as to have a minimum impact on exchange markets".

10. In implementing your policy decisions, do you effect transactions through other central banks, or domestic or foreign commercial banks, or brokers, or other partners?

Respondents' answers

Most respondents said they dealt through all channels, including foreign central banks, commercial banks, investment banks, and, in two cases, also through securities houses. Only some banks, however, deal through brokers.

A G-10 central bank said it dealt with other central banks, domestic and foreign commercial banks and brokers. It added, "It is also possible to diversify passively through receipts from customer business".

The central bank of an industrial country outside the European and American area said its reserve transactions were conducted mainly with foreign commercial banks, adding, "The dollar balances at the New York Federal Reserve Bank are our only sizeable holdings with a central bank".

Only two respondents said they dealt exclusively or almost exclusively with foreign central banks alone. At the other extreme, a newly industrialized country said, "We seldom engage in reserve transactions with central banks".*

PART 2: THE EVOLUTION OF THE SYSTEM

11. Hitherto, reserve currency diversification appears to have been greatest among oil-exporting countries, developing countries, and some smaller industralized countries. Do you think that the practice may spread to the bigger industralized countries over time?

Respondents' answers

The answers to this question confirmed yet again an important development referred to also in answers to previous questions. While it is true that countries outside the Group of Ten have been most active in the currency diversification and portfolio management of their reserves, some G-10 central banks have also begun to diversify the currency composition of their reserves while others, who have not as yet taken that step, have nevertheless begun to manage their dollar holdings more actively.

Most respondents to this question expect reserve currency diversification to spread over time also to those large industralized countries that still hold their reserves in dollars alone, excepting for some working balances in other currencies.

* Relations between central and commercial banks long predated diversification. Several occupied European countries held assets at American commercial and investment banks from 1939 to 1945 or even earlier and maintained relations with them thereafter. In addition, a number of foreign central banks used US commercial and investment banks for transactions in US government securities and in consequence held some of their dollar balances with those banks. This, in turn, generated other business between New York banks and foreign central banks. Long-established relationships therefore existed to help get reserve asset diversification under way, once it started. Many central banks, especially in non-industrial countries, hire western commercial and investment banks to manage parts of their reserves. Typically, the amount to be managed is allocated to the commercial or investment banks every six months and the management fee is usually between 5 and 10 basis points, or 0.05 to 0.1 per cent of the assets managed. Under an arrangement described as fairly widespread, one developing country employs three commercial and investment banks to manage parts of its reserves. If any of the three banks performs less well than the other two for two successive periods of six months, its contract is ended. The information in this footnote was derived from private bankers interviewed in connection with this survey.

One large G-10 bank reported that "There is already some evidence of diversification among the larger industrial countries and this is likely to continue, especially when they adopt a strategy of public sector external borrowing". Another G-10 central bank stated: "Many of the reasons for reserve currency diversification also seem applicable to larger industralized countries". Yet another said, "Some of the larger countries appear to have shown some interest in reserve currency diversification and this may spread, for example, in the context of the EMS".

A central bank from a non-G-10 industrial country pointed out that, contrary to the view implied in the question, LDCs had in fact been "slow to catch on"; LDCs did not diversify on a large scale "until huge upheavals in the markets and the examples of some industrial countries persuaded them to do so".

The central banker who made this observation mentioned two leading G-10 countries which "were aware much earlier of what was happening," adding "all those with flexibility have already diversified to some extent".

Several central banks based their replies on the expectation, or supposition, that the motives for diversification outlined in answers to question 1 would continue to apply but some stated that they expected the practice to spread only if monetary cooperation between the major countries were to break down.

Two central banks from the European Community (EC) took the view in almost identical language, that the extent of diversification would largely depend on US exchange rate policy. Others pointed out that the room for maneuver was limited by the size of some countries' reserves, and the commitment of leading countries to attempt to ensure "orderly markets".

Only two respondents answered the question unambiguously in the negative. They were both from the Middle East. "There is little likelihood of such a spread because the big industrial and other countries face different circumstances", said one of them.

12. What, in your opinion, are the merits and demerits of the SDR as a reserve asset? What growth do you expect in the official use of the SDR. Will its growth offer a useful alternative to the multiple reserve asset system now prevalent?

Respondents' answers

Only one central bank, from a small country, said that it expected the SDR to become in time a practical alternative to the multiple reserve asset system (and even that respondent qualified its answer). The great majority

of central banks expect its role to remain modest, and there was surprisingly little difference of view between industrial and developing countries. Respondents dwelt on the disadvantages of the SDR, sometimes expressing these in terms of the changes that would have to be made for the SDR to become more usable. Among these, the most frequently mentioned were its limited usability (not only acceptance and designation rules and the balance-of-payments "need" requirement, but also that it is not an intervention asset and not transferable to the private sector). Other drawbacks cited were its lack of a range of maturities, relative lack of liquidity, and "lack of anonymity"; and that as an asset its yield, while "stable", is almost certainly lower than the average return on liquid assets held by central banks in the markets of the currencies making up the SDR "basket". For many countries its currency composition was not deemed appropriate to their patterns of trade or the composition of their external debt. For the system as a whole, it would also be necessary to control the growth of other reserve assets before the SDR could assume a dominant, or even an important, role. Several banks saw no justification for further allocations at present.

13. What growth do you foresee in the private market use of SDRs and how far might greater official and private use reinforce each other? Do you foresee circumstances in which the SDR could be used for intervention?

Respondents' answers

Central bankers appeared skeptical about the scope for growth in the use of the SDR in commercial transactions in the absence of (1) a demonstration of confidence in it by governments, such as further allocations and IMF borrowing denominated in SDRs in the markets; and (2) greater interest on the part of borrowers. To some extent official and private use has already reinforced each other, for instance through Fund borrowing from surplus countries denominated in SDRs. The simplification of the SDR valuation basket to the five leading currencies has certainly helped to encourage greater private use.

Central banks did not envisage the SDR being used for intervention in the foreseeable future. This could be foreseen only if private holdings of the IMF's SDRs were permitted and the IMF instituted a clearing mechanism. "Strong opposition by many countries to privately-held SDR accounts because of the fear that they will undermine the collective management of reserves is likely to operate against the use of the SDR for intervention purposes," said one central bank.

14. Do you envisage any currencies other than the dollar assuming larger roles as intervention currencies over time? If so, which and why?

Respondents' answers

A few respondents foresaw the Deutschemark acquiring a more important role as an intervention currency within the EMS and three central banks, of which one was from South-East Asia, said that the yen could "conceivably" play a more active role in the trade and payments of Asian countries. However, central bankers agreed that the dollar would remain the dominant intervention currency. One G-10 central bank envisaged the possibility of a convergence of the "nth-currency dollar system" and the "multi-intervention EMS", as suggested by occasional reference to a "common dollar policy" within the EMS. (In its view, such a policy would require the cooperation of the US monetary authorities). This bank added a caveat:

"Multiple currency intervention risks being indeterminate in its effects on exchange rates unless subject to well-defined rules as in the EMS. We see obstacles to its more general application outside closely-knit arrangements for coordination in other areas of policy such as attempted within the European Community".

Apart from the reasons usually given for the dominant role of the dollar as an intervention currency (the role of the dollar in the currency markets, its ready availability and the size and breadth of the US markets) one bank noted that accumulation of reserves in other currencies was limited by "the necessity to secure the prior permission of the issuing authority".

Another stated that over time, as diversification proceeds, the distinction between an intervention currency and a reserve asset could fall away: "Certainly the Deutschemark could become more generally used, particularly if the US were to revert to market intervention."

15. What growth do you foresse in the role of the ECU
    a) as a reserve asset
    b) in private transactions?

Respondents' answers

Central banks from outside the EC did not show much interest in the future of the ECU and several did not answer the question. Banks from EC member countries said they saw the "potential" for growth and focused

their answers on the changes that would, in their view, be required for the ECU to become a fully-fledged reserve asset. One emphasized that it had to become a means of payment. Typical of other replies is this one, quoted in full:

"We see a potential for growth of the ECU both as a reserve asset and in private sector transactions paralleling the further development of the EMS as a 'zone of monetary stability' (comprising exchange rates as well as prices and domestic monetary conditions). However, such growth will be conditional on the characteristics and qualities of the ECU as a denominator of financial claims and liabilities; these characteristics may have to be improved on, including the rules governing changes in the currency composition, its convertibility into reserves useable outside the EMS (dollars) etc. The future of the ECU will also depend on the status of the European Monetary Fund which has yet to be created as part of the move into the institutional phase of the EMS".

16. What is your present attitude towards the "substitution account" proposed in 1979-80, that is, a substitution of SDR claims on the International Monetary Fund for some of the dollar claims on the United States represented by foreign official reserve holdings? What are the main factors influencing your attitude towards this proposal?

Respondents' answers

Most central banks began their replies by indicating that they were in principle in favor of a substitution account — or thought that interest in the idea would revive — but devoted the rest of their replies to pointing out the theoretical and practical difficulties of the 1979-80 proposal, often saying also that the renewed strength of the dollar made it less urgent to reconsider the question. It seems clear from the replies that any new scheme would have to be significantly different from the 1979-80 proposal to stand a chance of acceptance.

Two G-10 banks were openly hostile, and others skeptical. One said that such an account "could conceivably add to incentives for shifting among alternative reserve assets" and "tend to impede the adjustment process" by reducing pressure on countries to correct an underlying disequilibrium in their economies. Another G-10 central bank said that if dollar creation was excessive "substitution of dollars would be tantamount to a balance of payments support facility for the United States". Two others said that because of the volatile interest and exchange rate movements caused

by varying national monetary policies, a substitution account could play a marginal role. This and another large G-10 central bank indicated that such an account might not be limited to dollars — it could lead to calls for comparable facilities for other currencies — though one of these respondents seemed to regard this as a problem and the other as an opportunity.

The major technical problem mentioned in many replies related to the bearing of the exchange risk and "amortization". At a practical level, one leading central bank doubted whether large amounts of dollar claims (or other currencies) could be "mobilized to be demobilized" in a substitution account, at least while the dollar was expected to remain strong.

Developing countries, including oil producers, were generally more favorably disposed. They too, however, had far-reaching criticisms of the 1979-80 scheme. Among these were that it did not provide for inclusion of private holdings, it did not create SDRs but only SDR-denominated claims; that participants' commitments might extend to direct financial support and that the availability of funds in the Euromarkets might be affected.

17. What role do you envisage being played by gold
    a) In the international monetary system?
    b) In central banks' reserve policy?
    c) For domestic monetary purposes?

Respondents' answers

Respondents were unanimous in saying that they can envisage no role for gold in the international monetary system or in domestic monetary systems at any forseeable time and only a very limited role, if any, for gold in central banks' reserve policy.

The view was put brutally by the central bank of one of the G-10 countries which had had the reputation of a strong attachment to gold in the 1960s. It said, "We do not believe that a return to some form of gold standard is either desirable or feasible. Gold will, in our opinion, simply continue to play the role of a residual component in central bank portfolios".

Another G-10 central bank, among the world's top half-dozen in its holding of gold reserves, said: "We do not believe that a revival of the gold standard is desirable or, indeed, feasible. We do not believe, in particular, that the objectives of external and internal stability would be served by anchoring the international monetary system to an exogenous standard's

arbitrary quantity and price, nor that the latter magnitudes could be adequately controlled to ensure the desired growth of international liquidity and international adjustment". As to gold in national reserves, it added: "The main problem is how to mobilize gold in case of need without affecting the private markets". In that connection, some respondents referred to gold in central bank vaults as "crisis" reserves or "war chest" reserves.

Some European central banks noted that the European Monetary System had begun to provide at least a limited role for gold in official transactions. One of these pointed out that in the EMS, 20 per cent of gold serves as a counterpart of ECU creation, resulting in partial mobilization of gold for indirect use in settlements within the EMS, albeit it on a provisional basis and without any permanent transfer of gold taking place.

18. It has sometimes been argued that a multiple currency reserve system may have some advantages — e.g. that it spreads responsibility for managing the system to a wider group of countries — that compensate for its alleged disadvantages. What in your opinion are the main benefits or drawbacks of a MCRS?

    Do you share the view that a MCRS is likely to prove "inherently unstable"?

Respondents' answers

Only a small minority of respondents described the MCRS as "inherently unstable". The majority view can be summarized under three headings:

i) The MCRS is the only practical system at present and its very existence shows that it is preferable to alternatives that have failed, or which respondents have little hope of achieving;

ii) That the MCRS may contribute marginally to international instability, but far less than fundamental disequilibria in the world system and the resulting private capital flows, which are far larger than official flows;

iii) That the MCRS could or, indeed, already does contribute to some greater stability at the margin.

Under the first heading, a G-10 central bank said, "In present circumstances there is probably no alternative to the *de facto* MCRS". Another G-10 central bank commented, "If the alternative is seen as a dollar standard or a poor functioning SDR standard, the MCRS appears to offer some advantages".

Comments under the second heading included this, from a leading G-10 central bank, "Other factors making for exchange rate instability may be more relevant than the existence of the MCRS in itself, such as rapidly changing payments imbalances, varying inflation differentials and the greater variability of interest rates". Another G-10 central bank observed that "The size of private holdings of foreign exchange now so dwarfs official reserves that it needs more than an understanding about reserves to ensure stability".

Under the third heading, several respondents said an evolving MCRS does or could contribute marginally to greater exchange rate instability in the absence of greater policy coordination between the United States and the newer, secondary reserve centers. However, for that very reason, several respondents thought the MCRS might reinforce market signals imposing a quicker and more coordinated adjustment by the reserve centers.

Beyond that, about a third of the respondents saw a range of positive advantages in the MCRS. One G-10 central bank is worth quoting at length:

> "Insofar as official holders are concerned, the experience of recent years suggests that the large new holders of reserves, primarily the OPEC countries, have generally acted in a rational way, responding to market forces in the light of their own longer-term interests. Indeed, at times official flows have moved in an opposite direction to private flows. Even if official flows reinforce pressure from private flows, this may not always be inappropriate where necessary adjustments are unduly delayed."

19. What alternatives, if any, do you see to the present *de facto* MCRS in present conditions?

Respondents' answers

The overwhelming majority of respondents said they can envisage no alternative to the *de facto* MCRS in present or foreseeable circumstances. Indeed, the view that the major powers positively want the MCRS that has come into existence was put by the monetary authority of an important oil-exporting country, which said, "Since the present attitude of the majority of industrial countries is not favorable to SDR creation, it appears that the majority of the IMF's voting power is implicitly in favor of the present MCRS. Therefore, if we are to be realistic about possible developments under present circumstances, we can assume that there is no alternative to the present *de facto* MCRS".

Among the minority of respondents, a G-10 central bank urged, as an alternative to the MCRS or as an approach that would remove the reason for its existence, greater persistence in the fight against inflation internationally which would, of itself, contribute to greater exchange rate stability. Another G-10 central bank said an increased use of composite units like the SDR and ECU "could be envisaged, but cannot be achieved in the short run".

20. Is it worth considering the possibility of any sort of understanding between reserve centers and reserve holders over the pattern (and rate of change of composition) of their currency holdings — on the basis perhaps of various criteria such as trade and investment patterns? Any comment or suggestions that you would wish to make on this or other policy-related issues would be much appreciated.

Respondents' answers

More than half of the respondents said that they doubted whether any general understanding between reserve centers and holders could be achieved. Some central banks said an effort at general understanding would be "worth" making, but they did not specify how, nor did they indicate how successful they think such efforts might be.

The emphasis of other replies was on informal rather than rigid understandings, on bilateral rather than multilateral arrangements, and on flexibility.

Among the minority holding hope for some form of understanding was a G-10 central bank which said, "It is possible to contemplate some sort of arrangement between reserve centers and reserve holders on a more general basis, as opposed to more limited and temporary schemes involving a particular currency at a particular time*. In practice, such an arrangement would probably center on the G-10 and Switzerland and possibly include one or two other countries meeting regularly at the Bank for International Settlements in Basle. These are not, however, the central banks whose behavior has been most disruptive in the past".

A G-10 central bank outside the European area made the following comment: "It is conceivable that circumstances could develop where some sort of understanding between one or more reserve centers and reserve holders might be desirable, as was the case in the past with sterling

* Special arrangements of the kind referred to here were at one time made with official sterling holders.

balances. However, the issue of coordination of policy is much broader in scope than the question of changes in the composition of reserve holdings. The mechanism in place for multilateral consultation on policy issues and for monitoring developments appear to be broadly adequate and may be supplemented through bilateral discussions. These mechanisms have proved capable of providing the basis for arriving at pragmatic arrangements when circumstances warranted".

Among the doubters, a G-10 central bank said, "We fear that the same problems that have been instrumental in not bringing about the orderly system envisaged at the time of the inception of the SDR will also hamper efforts directed at bringing more order into the MCRS". Another G-10 central bank commented, "Agreements are likely to prove difficult to achieve as long as common interests are not more clearly perceived. Reserve holders would probably be prepared to see their freedom of choice reduced only if reserve centers offered guarantees with respect to the exchange value and convertibility of their holdings. Private holders would probably not be much influenced by official agreements anyhow".

And, more tersely from the monetary authority of an important oil-exporting country, any arrangement or arrangements "would involve great efforts in terms of financial diplomacy".

STATISTICAL APPENDIX

The extent of the shift to a multiple reserve and asset currency system is difficult to measure precisely, because of imperfections in the data available. Some countries do not fully disclose their reserve holdings to international agencies. There are, moreover, difficulties in reconciling the data published by the International Monetary Fund on the foreign exchange reserves of its member countries and the estimates published by the Bank for International Settlements on liabilities to other countries reported by the commercial banking system. This reflects in part, but only in part, the fact that many countries hold foreign exchange not only in the form of official reserves on the books of their central banks, but that they also have foreign exchange assets owned by other official agencies. The latter, often less reported even than official reserves, may not be as readily mobilized as reserves held by central banks, but they are nevertheless foreign exchange assets and may be called quasi-reserves or secondary reserves. If reserves and other foreign exchange holdings could be taken into account, it is possible that official currency diversification may have been greater, at least periodically, than shown by the imperfect statistics.

However, for all those reservations, the admittedly imperfect and provisional data so far made available to the Group of Thirty are, at least, consistent. Tables 1 and 2 show a trend, while Table 3 captures a moment in time.

The tables confirm that diversification has so far been far more pronounced on the part of non-industrial countries, thus bringing out the difference between central banks which hold reserves mainly for intervention on the exchanges and others which hold varying portions of their reserves as asset portfolios. Movements in the proportion of global reserves held in dollars also depend on whether those countries gaining reserves are 'diversifiers' or not. The level and rate of increase of reserves (as compared with past experience and expected 'needs') also appears to be a factor. This is shown clearly in Table 2. The proportion of dollars in the reserves of non-industrial countries rose at the start of the 1972/73 commodities' boom and again after the first large increase in oil prices in 1973. In each case it seems to have taken time before new dollar receipts were diversified.

TABLE 1

Composition of foreign exchange reserves

Industrial countries

Currency equivalents of SDR values

per cent

End of:	$	Pound	DM	Yen	Swiss fr	Effective $ Exchange Rate
1970	85	5	2	0	1	100
1971	82*	4	2	0	1	97
1972	86*	4	3	0	1	90
1973	86	3*	3	0*	1	83
1974	87	2*	3	0*	1	85
1975	88	1*	4	0*	1	84
1976	84	1*	3	0	1	88
1977	89*	1*	4	0	1	88
1978	86*	1	6	0	1	80
1979	84	1*	6*	2*	3	79
1980	79	1	11*	2*	3*	79
1981**	79	1	11*	2	2	83

* Years in which countries marked ran current deficits.

** 1st quarter

Calculations based on preliminary IMF data. The dollar component of ECU holdings has been shifted to the dollar column and the gold content of ECU holdings has been eliminated.

NB. Real $ interest rates were negative from 1972 to 1977 and nominal until early 1980.

TABLE 2

Composition of foreign exchange reserves

Non-Industrial countries

Currency equivalents of SDR values

per cent

	$	Pound	DM	French Franc	Yen	Swiss Franc	Dutch Gulden	Effective $ Exchange Rate
1970	57	20	2	3	0	0	0*	100
1971	42*	18	5	4	0	1	0*	97
1972	55*	12	14	5	0	2	0	90
1973	47	9*	25	5*	0*	4	1	83
1974	67	11*	10	2*	0*	2	1	85
1975	70	7*	9	2*	1*	2	1	84
1976	73	3*	10	2*	2	2	1	88
1977	69*	3*	12	2*	2	3	1	88
1978	61*	3	14	2	4	3	1	80
1979	62	3*	16*	2	4*	3	1*	79
1980	58	5	15*	2*	5*	5*	1*	79
1981**	59	5	15*	2*	5	5	1*	83

* Years in which countries marked ran current deficits.

** 1st quarter

Calculations based on preliminary IMF data.

NB. Real $ interest rates were negative from 1972 to 1977 and nominal until early 1980.

TABLE 3

Composition of foreign exchange reserves by country groups

1st quarter, 1980
per cent

	Industrial Countries		Oil Exporters	Non-Oil LDCs
	EMS	Other		
Dollar	90	83	67	68
Pound	0	1	3	6
DM	6	9	17	18
French franc	0	0	2	2
Yen	0	4	5	4
Swiss franc	3	3	5	2
Dutch gulden	1	0	1	0

Source: George M. von Furstenberg, IMF Survey, January 26, 1981, p. 28.

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Group of Thirty

The Group of Thirty was established in December 1978, to explore basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as a basis for the Group's discussions.

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Group of Thirty

How Bankers See the World Financial Market

A survey by the Office of the Group of Thirty
on behalf of the
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How Bankers See the World Financial Market

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How Bankers See The World Financial Market

Preface

Are the risks in international banking increasing? How do banks seek to protect themselves against such risks? What view do bankers take of the activities of bank supervisors? These are among the questions addressed by bankers themselves in the following survey.

The survey has grown out of the Group of Thirty's continuing work on international banking, which complements the Group's other work on exchange rates, the flow of finance to developing countries, the reserve management policies of central banks and the energy markets, among other subjects (a list of current publications is given on the inside of the back cover). Because of the crucial role played by the international banking system in many of the central issues facing the international monetary system, the Group of Thirty decided in mid-1980 to set up a special study group to monitor developments in the international money and capital markets. The study group meetings are attended by present and recently-retired central bankers and supervisors, as well as practicing commercial and investment bankers. At an early stage in its deliberations, the study group decided to solicit the views of a wider group of bankers on a number of policy issues with this objective, and to try to gain more information about banks' international activities. It commissioned the Office of the Group of Thirty to draw up a questionnaire and conduct a survey of banks. This publication is the result of that exercise. It should be read, however, in conjunction with the study group's own report, published under the title *Risks In International Bank Lending*. The survey throws light on the practices, views and concerns of commercial and investment bankers; the

study group report evaluates these results, places them in a wider context, and makes a number of recommendations addressed to bankers and banking authorities.

The questionnaire was distributed to some 200 banks late in 1981. By February of this year, 111 banks had replied. Their answers were coded and processed by computer, and the resulting tabulations are given in the statistical analysis at the end of this report. The report on the answers, which draws also on interviews conducted with 30 banks, forms the text of the report, starting on page 7. The introduction summarizes the results.

Of the 111 banks responding, 29 have headquarters in North America (of which 22 are from the United States), 55 have headquarters in Europe, and the remaining 27 include banks from countries outside these regions as well as 9 consortium banks, mostly based in London. Many of the banks are quite large, with 68 appearing on a list of the top 250 world wide. Nearly all of them are very active in international markets. About 50 per cent of the banks report that their international loans account for more than 25 per cent of their total loans, while more than 80 per cent report that their international assets and earnings have grown faster in the last five years than their domestic assets and earnings. Furthermore, 80 per cent expect that trend in assets and earnings to continue.

As in previous surveys conducted by the Group of Thirty, respondents were promised absolute confidentiality; answers were seen by the staff of the Group of Thirty alone.

The Group of Thirty owes a deep debt of gratitude to the banks that responded to the survey; the willingness of the senior management of so many banks to complete a lengthy questionnaire (51 questions over 16 closely-typed pages) is itself striking evidence of the seriousness with which this subject is treated by the international financial community. The Office of the Group also wishes to thank Ms. Judith Walter, Mr. Chuck Muckenfuss and Mr. Steven Weiss for their expert assistance in preparing the questionnaire; Professor Peter B. Kenen, who gave invaluable advice on coding and processing the results; and Mr. M.S. Mendelsohn, who took the leading role in writing the report, ably assisted by Ms. Sheerin Ardalan and Ann Tutwiler. As usual, final responsibility for the contents, and for any inaccuracies that remain, rests with the undersigned.

Robert Pringle
Executive Director
Group of Thirty

May, 1982

How Bankers See The World Financial Market

Introduction

This report, like an earlier study,[1] is based on the view which bankers themselves take of the modern international capital market. But it goes further in being far more comprehensive. It is based on answers given by 111 commercial, investment and consortium banks in 30 countries of the industrial and developing worlds to 51 questions, many of them multiple questions. That is more than double the number of questions and responses on which the earlier report was based. There is more emphasis this time on the attitude of bankers not only to their market, but also towards official regulation, the competence of supervisors and the competence of the authorities. Above all, the present study contains a far more extensive statistical analysis of bankers' answers, processed by computer and designed to allow readers to form their own conclusions.

The broad picture which emerges from this study is that a majority of bankers expect their international lending and earnings to go on growing faster than their other business in the coming five years although less rapidly, perhaps, than in the past five. At the same time, however, bankers are becoming somewhat more concerned about the international market and the ability of the authorities to act promptly in case of need. And, while this study concentrates on international banking risks, it is impossible to divorce those from domestic banking risks. In interviews, several bankers referred to the increasing pressure on corporate balance sheets and a growing number of company bankruptcies in Western countries. A further deterioration in this respect could pose a serious challenge to the banking system if it coincided with more reschedulings of cross-border loans.

[1] "The Outlook for International Bank Lending," Group of Thirty, August, 1981.

Such concerns have to be taken seriously, but should also be put into perspective. Bankers need to be cautious by the very nature of their business as custodians of other people's money. "Concern" on a banker's part is not, therefore, always synonymous with "worry". That is why many questions have been broken down to ask respondents to rate the degree of their concerns, as best they can, as being "serious," "moderate" or "minor." Moreover, the answers to several questions show that banks are taking greater precautions in the international market, especially in their evaluation of borrowers and in their assessment of other banks with which they place funds in the Euromarkets.

Similarly, when bankers say that the system would be "vulnerable" to a certain risk — for example, "vulnerable" to a "chain collapse" of the banking system in the event of a crisis affecting a significant bank or group of banks — this does not mean that they consider such an eventuality to be likely. Indeed, in the example quoted above their supplementary comments made clear that they consider it most improbable.

While this study concentrates on bankers' views, their answers provide, also, some important new factual information. The very active extent of trading in the international interbank market (the Euromarket) is statistically shown in the answers to Question 44. Another arresting development is the new priority which banks give to political trends, following events in Iran, Poland and elsewhere.

Principal Results

Some of the main conclusions that emerge from the study are:

Prospects for International Lending and Earnings

- About 75 percent of respondents expect their international lending and earnings to go on growing faster than other business in the next five years, but only a quarter expect a "substantial" increase compared with half which actually experienced such an increase in the past five years (3 and 4);[2]
- About 75 percent said international lending in the past five years had proved as profitable or more profitable than domestic lending (5);
- More than 40 percent of respondents think international lending risks will increase "substantially" in the next five years, compared with 25 percent who said the risks had increased "substantially" in the past five years (6);

Country Risk and Reschedulings

- The main threats to individual banks were listed in the following order: default by a major borrowing country; large numbers and amounts of reschedulings; foreign exchange losses; losses from mismatching of maturities and currencies (7).
- Large numbers and amount of reschedulings were seen as the main threat to the international banking system;

[2] Numbers in brackets refer to the questions and the tables in the Statistical Section.

- More than 90 percent of banks said they had increased the resources devoted to country risk analysis in recent years (22);
- Banks now give political analysis priority even over economic analysis in their assessment of country risk (31);
- Both in international lending and in placing funds in the international interbank market, most banks say they rely on their own judgment above all others (like analyses from international institutions, the views of other banks or reports from outside consultants) (26, 32, 49);
- Nearly all banks have centralized systems for reviewing country lending limits and about two-thirds set limits by maturity as well as amount (deciding, for instance, that only a part of the total approved be lent at, say, more than one year) (30);
- A majority of banks believe that more cofinancings with official institutions might help reduce the system's risks (33);
- More than half of the respondents think the indirect costs of reschedulings could become a "significant" concern in the future. At the same time, more than half are unsure whether existing rescheduling arrangements are satisfactory and nearly 20 percent believe they are not (34 and 36);

The Interbank Market

- A new breakdown shows extremely active trading in the international interbank market (or Euromarket). Half of all respondents say they regularly redeposit with other banks more than 40 percent of funds obtained in the market and a quarter of the respondents normally redeposit more than 60 percent (44);
- About half the respondents think that interbank activity is becoming more risky as a result of the change of composition of participants. However, about the same proportion deny that interbank trading is "excessive"; a minority believes it to be "excessive" at some, mostly smaller banks; less than 10 percent of respondents describe it as "excessive" for the system as a whole (45);
- Nearly all banks say that they set overall and daily limits on interbank placements. Mostly limits are set on an assessment of the bank with which the funds are to be placed as well as an assessment of that bank's country of origin (47);

Banking Supervision and Crisis Management

- A majority of American banks (and a minority of European and other banks) complain of burdensome regulations which could be modified or dropped without impairing prudential control (12);
- American bankers feel more strongly than any other group that regulation by their authorities puts them at a disadvantage in international competition (8);
- Capital requirements were mentioned most often as imposing a competitive disadvantage (9);
- The change in regulation most desired by a majority of respondents is "harmonization" in the major financial centers to reduce the market distortions which they say result from differences between national regulations and supervision practices (16);
- About 60 percent state that the system would be vulnerable to a "chain collapse" in the event of a crisis affecting a significant bank or group of banks (21);
- Nearly 80 percent of respondents think the authorities should give sup-

port in a liquidity but not a solvency crisis. However, 60 percent believe it is not feasible to distinguish between the two in an emergency (20);

- About three-quarters of the respondents believe there is need for clearer understanding about lender-of-last-resort facilities for distressed banks (21).

How Bankers See The World Financial Market

Report on banks' answers to the questionnaire

1. THE INTERNATIONAL BANK LOAN MARKET

International lending and earnings

More than 40 percent of the banks in this survey think international lending risks will increase "substantially" in the five years to 1986 (6).* Nevertheless, a quarter of the respondents expect a "substantial" relative increase in their international business in the five years ahead; this compares with almost half which reported having experienced a "substantial" increase in the past five years (3 and 4). More than 75 percent anticipate that there will be some relative growth in their international lending and earnings.

The expectation of continuing growth is explained partly by the wide range of services which banks consider as "significant" aspects of their international operations (1).

Profitability

The relative profitability of international lending in the past five years emerges from answers to Question 5. About three-quarters of all respondents said it has been as profitable or more profitable than domestic lending. However, answers differed considerably between regions. International lending was reported to have been relatively more profitable by over 70 percent of respondents from Asia, the Middle East and Latin America, but by 55 percent of those from North America and a third of those from Europe.

* Numbers in brackets refer to tables in the Statistical Section. They do *not* refer to the summary tables in this text.